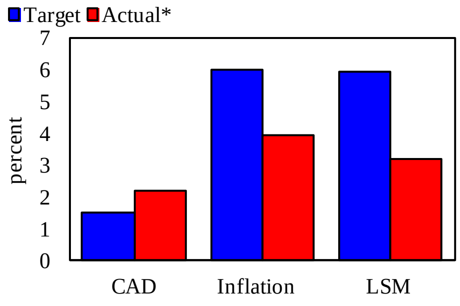
3 Inflation and Monetary Policy

3.1 Policy review

Broad macroeconomic conditions continued to guide monetary policy decisions during Q3-FY17. Around the January deliberations for monetary policy, the available data was showing a lower growth of large-scale manufacturing (LSM) as well as a subdued inflation – significantly lower than the target (**Figure 3.1**). On the other hand, domestic demand was gaining ground as evident in rising imports; steady increase in core inflation; and a sharp rise in private credit from Q2-FY17 onwards. Importantly, the current account deficit almost doubled in the first half of the year compared with the same period last year, resulting in a reduction of SBP's liquid foreign exchange reserves. Keeping in view these trends, the Monetary Policy Committee (MPC) decided to keep the policy rate unchanged at 5.75 percent.

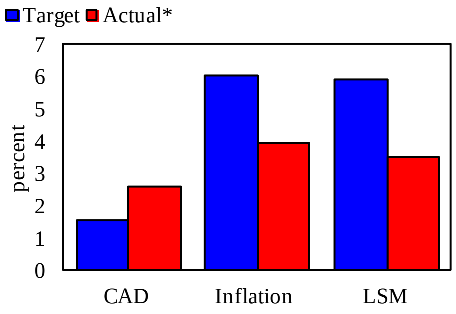
Figure 3.1a: Key Indicators for Jan 2017 MPC Meeting



* H1 for CAD (as % of GDP) and inflation (YoY CPI); Jul-Nov for LSM

Data source: Planning Commission, PBS and SBP

Figure 3.1b: Key Indicators for Mar 2017 MPC Meeting



* Jul-Feb for CAD and inflation; Jul-Jan for LSM

By the time the next MPC meeting was held in March 2017, the external sector challenges had deepened further. Also, while the YoY CPI inflation during Jul-Feb was unchanged from its H1-FY17 average, YoY inflation for February 2017 (4.2 percent) and underlying demand pressures captured by measures of core inflation suggested that the upward trend in inflation would most likely continue.[1,2] Meanwhile, to add to uncertainty for policymakers, LSM fluctuated

[1] YoY CPI inflation during both H1-FY17 and Jul-Feb FY17 averaged 3.9 percent.
[2] NFNE inflation increased to 5.3 percent in February 2017, from 4.5 percent in February 2016.

sharply in December 2016 and January 2017.[3] Thus, following the need to maintain macroeconomic stability, the MPC decided again to maintain the status quo.

The decision to continue with the low policy rate regime helped maintaining the growth momentum in private sector credit, which had gathered tremendous pace from Q2-FY17 onwards. This policy support became crucial because a large part of recent bank lending appears to be financing firms' capital expenditures. In Jul-Mar FY17 also, 42 percent of the total increase in businesses' credit came from fixed investment loans.

Apart from being a direct outcome of low interest rates, this trend also reflected an improvement in the investment climate manifested in the country's better risk perception and an improved energy outlook. Sugar, cotton, ready-made garments, cement, steel, dairy, petroleum refineries, fertilizer – virtually all major sectors availed more fixed investment loans during Jul-Mar FY17 compared to last year. Meanwhile, higher input prices and greater availability of raw materials (e.g., sugarcane and cotton) stimulated the demand for working capital loans by related industries.

On the supply front, banks were better placed to cater to this demand, on the back of high deposit generation during the year, and more importantly, net retirements by the government to commercial banks. Although banks' lending to the government increased in Q3-FY17, this did not have a significant impact on their liquidity since this period, as usual, coincided with the maturity of private credit cycle. Despite seasonal retirements in major sub-sectors therefore, the overall private credit posted a healthy expansion during the quarter. As a result, net expansion in private credit during Jul-Mar FY17 was 36 percent higher compared to the same period last year (**Table 3.1**).

Table 3.1: Changes in Monetary Aggregates
flows in billion Rupees

	Q3		Jul-Mar	
	FY16	FY17	FY16	FY17
Reserve money	99.3	50.3	433.6	314.3
Broad money (M2)	197.9	110.2	677.6	756.1
A. Net foreign assets	-66.7	-264.2	83.8	-284.8
SBP	-38.3	-189.7	141.4	-155.2
Scheduled banks	-28.5	-74.5	-57.6	-129.7
B. Net domestic assets	264.6	374.4	593.8	1,040.9
Budgetary borrowing*	354.8	287.6	538.0	694.7
SBP	-96.3	-100.5	-525.5	792.2
Scheduled banks	451.1	388.0	1,063.5	-97.5
Credit to private sector	27.7	77.9	323.4	438.6
Credit to PSEs	11.1	114.0	11.7	197.0
Other items (net)	-60.9	-24.6	-178.1	-166.9

*On cash basis
Data source: State Bank of Pakistan

[3] LSM grew 7.4 percent YoY in December 2016, followed by just 1.1 percent YoY in January 2017.

The impact of this stronger expansion on net domestic assets (NDA) of the banking system was reinforced by the growth-inducing fiscal stance, particularly an increase in development spending by the government. Budgetary borrowings from the banking system – mainly from SBP – remained higher than last year, as external and non-bank domestic financing could not fill the rising fiscal gap. A related and important development during this period was the sharp increase in credit to PSEs (especially energy-related). This can be traced to the re-emergence of circular debt, which apparently tightened liquidity conditions in the entire energy supply-chain.

As a result, the expansion in the overall NDA of the banking system was over 75 percent higher than the expansion seen last year. Thus, the stage was set for an acceleration in broad money growth, but this was not to be: M2 growth turned out to be marginally lower during Jul-Mar FY17 – and much slower during the third quarter – relative to last year.[4] The slowdown was entirely explained by the decline in NFA of the banking system, which continued for the third consecutive quarter of FY17. This decline mainly represented the rising deficit in the external account (**Chapter 5**).

So effectively, the trends in external imbalances had a bearing on monetary management in the country during Jul-Mar FY17. While these trends are likely to persist in the short-term, SBP will continue to strike the delicate balance between macroeconomic stability and growth. Here, it is important to reiterate that the effectiveness of pro-growth measures hinges upon the stability outlook of the economy.

3.2 Money market developments

Compared to the preceding quarter, liquidity conditions in the interbank market were somewhat tight in Q3-FY17. This was linked directly to an alteration in the government's pattern of budgetary borrowing: rather than primarily borrowing from SBP and retiring its debt to scheduled banks (as it had been doing during H1-FY17), the government opted to borrow from scheduled banks during the quarter. As a result, the overnight rates remained 8 basis points above the policy rate on average during Q3, compared to around 2 basis points in the previous quarter. Commercial banks' recourse to SBP's reverse repo facility was also more frequent.[5]

---

[4] Broad money grew by 5.9 percent during Jul-Mar FY17, compared to 6.0 percent a year earlier. However, the growth rate during Q3-FY17 (0.8 percent) was almost half of the growth rate in M2 during Q3-FY16 (1.7 percent).

[5] Commercial banks availed SBP's reverse repo facility on 8 days during Q3-FY17, compared to 6 days in Q2; moreover, in terms of volume, banks borrowed Rs 160.8 billion from the SBP window

These conditions necessitated higher intervention from SBP in terms of liquidity management. Specifically, the outstanding level of OMO injections – which had declined significantly during Q2 – reversed course, increasing from Rs 800 billion at end-December 2016 to Rs 1,100 billion by end-March 2017.[6] This proactive liquidity management fostered stability in medium- to long-term rates: the 6-month KIBOR, for instance, remained fairly stable (around 6.1 percent) during Jul-Mar FY17.

Reverting back to government borrowings, banks participated actively in all the T-bill auctions that were held during the quarter. In the seven T-bill auctions during the third quarter, scheduled banks placed bids in excess of the auction targets (**Figure 3.2a**). The government duly raised a combined amount of Rs 441.3 billion (net of maturity) from the auctions.[7] From scheduled banks' perspective, there was a clear preference for shorter tenor T-bills (3- and 6-month), indicating their anticipation that interest rates had bottomed out.

Figure 3.2a: Auction Profile of T-bills

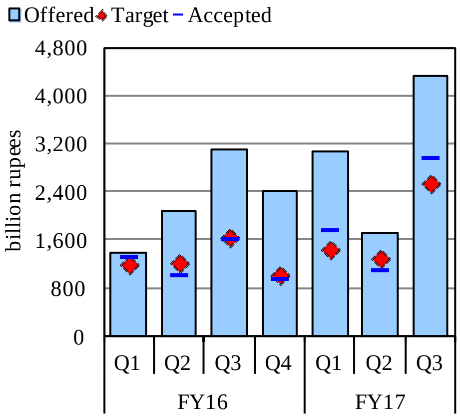
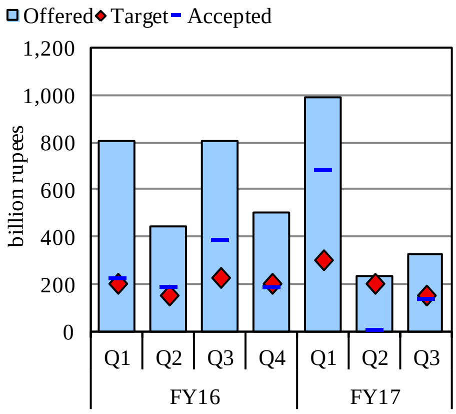


Figure 3.2b: Auction Profile of PIBs



Data source: State Bank of Pakistan

This anticipation was also reflected in PIB auctions, where banks' participation was relatively muted as compared to T-bills. However, unlike the auction outcome of December 2016, when banks had bid for a very small amount at excessively high rates, all the three auctions in Q3-FY17 were successful (**Figure 3.2b**). Not only did banks increase the offered amounts (especially in the auctions

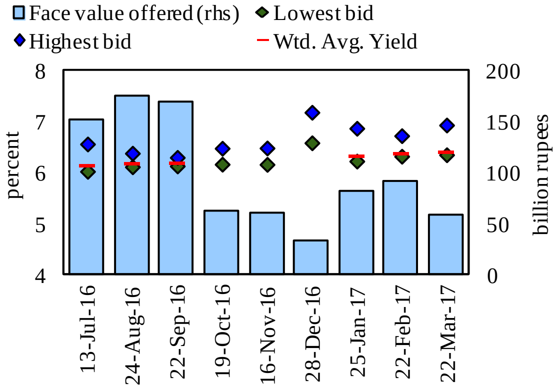
in Q3, compared to Rs 65.6 billion in Q2-FY17.

[6] For context, the outstanding level of OMO injections was Rs 1,147.3 billion at end-September 2016, and Rs 1,001 billion at end-March 2016.

[7] At face value; includes both competitive and non-competitive bids.

held in January and February), but the rate at which they bid at, was also fairly reasonable vis-à-vis previous cut-off yields (**Figure 3.3**). Overall, the government raised (net of maturity) Rs 132.4 billion from PIBs during Q3-FY17, against the target of Rs 150.0 billion. This was a markedly different outcome from the scrapped auctions of the previous quarter.

Figure 3.3: Bidding Pattern for 3-Year PIBs



Data source: State Bank of Pakistan

3.3 Monetary aggregates

In addition to the developments discussed already in **Section 3.1**, following changes in monetary aggregates were also noteworthy:

i. Reserve money growth slowed down during Q3-FY17, with flows equivalent to just half of the increase seen in the comparable period last year (**Table 3.2**). The slowdown occurred in spite of greater expansion in SBP's NDA during the quarter: the central bank stepped up its OMO injections to ensure that there was adequate liquidity in the interbank. Within NDA, there was a decline in budgetary lending as the government borrowed from commercial banks. However, the declining NFA of SBP (discussed in **Section 3.1**) eventually proved to be the major drag on reserve money growth during the quarter, as SBP actively sought to

Table 3.2: Factors Affecting Reserve Money
flows in billion Rupees

	Q3-FY16	Q3-FY17	Jul-Mar FY16	Jul-Mar FY17
A. Government sector, *o/w*	-96.6	-111.3	-534.9	804.2
Budgetary borrowings	-98.6	-113.6	-534.6	801.6
B. Non-govt. sector, *o/w*	1.8	14.1	22.5	97.4
Claims on scheduled banks	1.1	13.6	22.1	93.8
C. Other items (net), *o/w*	232.4	337.2	804.6	-432.1
OMO injection/ reverse repo	162.9	298.7	640.4	-408.4
D. NDA of SBP (A+B+C)	137.6	240.0	292.2	469.5
E. NFA of SBP	-38.3	-189.7	141.4	-155.2
Reserve money (D+E)	99.3	50.3	433.6	314.3

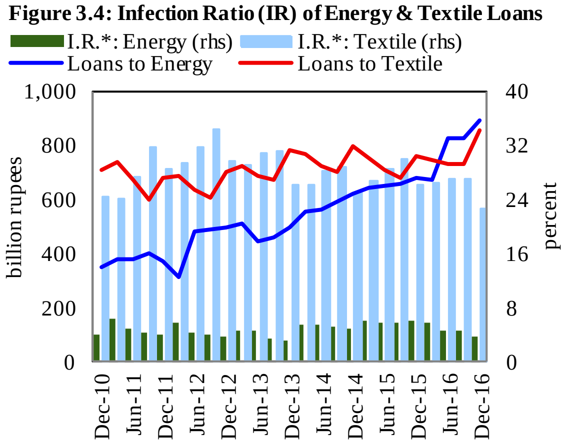
Data source: State Bank of Pakistan

minimize fluctuations in the foreign exchange market.[8]

ii. Credit availed by public sector enterprises (PSEs) was nearly 17 times higher in the current period compared to Jul-Mar FY16. In quarterly terms, the amount borrowed by PSEs during Q3-FY17 (Rs 114.0 billion) represented the highest credit off-take to PSEs in any quarter since Q3-FY12. Energy-related entities accounted for nearly 78 percent of this credit flow. Among the major PSE borrowers during the third quarter, WAPDA arranged financing for Rs 38 billion payment of hydel profit to the Punjab government for the years 2005-16; Power Holding Private Limited borrowed Rs 30 billion for the settlement of power sector payables; and PSO (classified as a PSE) availed Rs 15.3 billion financing to manage its liquidity constraints arising from circular debt.

iii. Partly as a result of the above, scheduled banks' exposure to the energy sector has shown a marked increase since FY14. Significantly, the concentration of loans to the energy sector overtook the traditionally largest borrower – textiles – in June 2015. The fact that energy sector loans generally carry low credit risk (most of these are government guaranteed), explains why scheduled banks have been comfortable extending loans to this sector aggressively (**Figure 3.4**). Effectively, energy projects pursued in tandem with public infrastructure tend to be as safe as government papers in terms of credit worthiness.

Figure 3.4: Infection Ratio (IR) of Energy & Textile Loans



Data source: SBP Financial Stability Report 2016

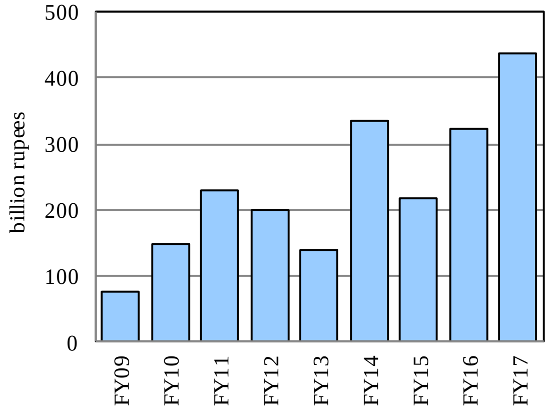
3.4 Credit to private sector

The resurgent activity of banks in the credit market continued during FY17: credit extension has crossed Rs 300 billion in three of the past four years (**Figure 3.5**). Both demand and supply-side factors were at play and reflected better

[8] NFA of SBP declined by 17.8 percent during Q3-FY17, compared to a 4.2 percent decline during Q3-FY16.

macroeconomic conditions, as evident in improved security situation and investment prospects triggered by CPEC.[9]

Figure 3.5: Credit to Private Sector (Jul-Mar)



Data source: State Bank of Pakistan

On the supply side, ample liquidity available with banks also contributed to higher credit off-take. Specifically, the ability of banks to extend credit increased during Jul-Mar FY17, thanks to impressively high deposit generation, lower government borrowing from banks, and modifications in subsidized SBP credit refinance schemes.[10] A better perception of the future in terms of investment opportunities and gains in asset quality also played a part in encouraging banks to expand their credit portfolios.[11]

The increase in credit to businesses sector was visible across all categories: working capital, fixed investment and trade finance (**Table 3.3**). While conventional banks continued to extend the biggest chunk of that credit, the combined share of Islamic banks and Islamic bank branches (IBBs) of conventional banks in the credit flow also increased (from 36.7 percent to 43.9 percent).[12]

---

[9] Even during FY15, there was considerable fixed investment borrowing by private businesses; the apparent slowdown in credit owed to lower demand for working capital loans, in the backdrop of depressed commodity prices. As a whole then, the FY14-FY17 pattern provides a marked contrast to the relatively uneventful FY09-FY13 spell in which credit reached at most Rs 200 billion during Jul-Mar periods.

[10] Banks generated deposits worth Rs 604.9 billion during Jul-Mar FY17 – the highest level since FY10 – compared to significantly lower mobilization of Rs 217.5 billion in the same period last year.

[11] This argument is based on discussions with commercial bankers regarding investment avenues and returns, as well as the decline in net NPL to net loans from 2.8 percent in March 2015 to 1.6 percent by March 2017.

[12] Unlike the case of conventional banks, there is a dearth of investment avenues for Islamic banks and IBBs, compounded by infrequent government auctions of Ijarah Sukuk. Thus, IBs and IBBs are aggressively competing with their conventional counterparts in the credit market.

Table 3.3: Loans to Private Sector Businesses (Jul-Mar)
flow in billion Rupees

	Total credit		Working capital		Fixed investment		Trade financing	
	FY16	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**	**FY16**	**FY17**
Total credit to private businesses	**249.0**	**368.4**	**65.4**	**150.9**	**140.3**	**155.1**	**43.3**	**62.4**
Of which								
1. Manufacturing	206.4	259.7	116.5	104.5	34.1	97.8	55.7	57.4
Sugar	56.9	101.1	51.7	79.3	4.7	15.5	0.4	6.2
Textile	82.5	87.0	58.0	35.5	9.3	26.2	15.1	25.3
Readymade garments	4.8	13.2	-0.6	0.4	1.0	4.3	4.4	8.5
Cement	-2.0	11.7	-3.0	-0.8	0.1	8.7	0.9	3.8
Dairy products	-1.7	10.3	-0.3	8.5	-1.8	2.0	0.4	-0.1
Refined petroleum and products	9.3	9.5	0.9	8.6	-6.1	4.2	14.5	-3.4
Fertilizers	28.2	-14.7	19.5	-26.7	5.9	10.9	2.7	1.0
2. Electricity, gas and water supply	39.8	38.3	13.0	21.7	31.9	14.2	-5.1	2.4
Production, transmission & distribution of electricity	37.8	39.5	12.7	22.1	30.1	15.0	-5.0	2.3
3. Construction	26.7	22.4	-2.6	7.4	28.1	15.8	1.3	-0.8
Roads	14.7	12.1	0.6	4.8	13.8	8.4	0.3	-1.1
4. Commerce and trade	11.3	19.3	4.0	21.0	7.1	-0.3	0.1	-1.4
Retail trade	10.6	19.3	3.3	18.2	5.0	-1.4	2.3	2.5
5. Mining and quarrying	-1.3	11.8	-2.7	-0.2	1.7	9.3	-0.3	2.7
6. Real estate	7.1	7.6	3.2	-2.5	1.0	6.4	3.0	3.7
7. Community and social service	7.1	0.6	6.1	1.9	1.2	-0.2	-0.1	-1.1
8. Agriculture	-1.4	0.1	-7.4	2.7	6.1	-2.4	-0.1	-0.2
9. Transport, storage and communications	20.9	-0.6	-9.2	-9.4	30.2	8.8	0.0	-0.1
10. Education	1.5	-6.2	-0.1	0.1	1.6	-6.3	0.0	0.0

Data source: State Bank of Pakistan

Sugar sector drove manufacturing loans

With more than 70 percent share in loans to private businesses during Jul-Mar FY17, manufacturing firms continued to be the dominant segment. However, unlike in the past when textiles dominated the credit market, sugar producers took a much larger share of the manufacturing credit in Jul-Mar FY17. Their higher demand for working capital loans was a result of impressive sugarcane crop this season. Furthermore, to capitalize on the available commodity surplus and exporting opportunities, the sector also scaled up its trade-related borrowings.

Capital expenditures spurred long-term loans

A number of sectors exhibited greater recourse to long-term financing from banks. For instance, borrowings of textile sector for fixed investment purposes remained stronger than last year.[13] An important contributing factor was the modification in SBP's subsidized financing scheme via which (i) the mark-up rate (end-user) exclusively for textile sector was reduced from 6 percent to 5 percent;[14] and (ii) the *entire* spinning and ginning sub-sectors were made eligible for availing the LTFF scheme.[15, 16] Over 90 percent of the increase in fixed investment loans during Jul-Mar FY17 by textiles was under the LTFF scheme. Similarly, in the cement sector, the initiation of a number of infrastructure projects and mega housing schemes has triggered impressive growth in domestic production and dispatches. To keep up with this demand, local manufacturers have undertaken aggressive expansion plans to increase their capacity. Moreover, firms in sugar, fertilizer, dairy, steel and petroleum refining sectors also availed more long-term loans.[17]

CPEC-related borrowing continued

Furthermore, the impact of CPEC activities was felt in credit developments within power, road infrastructure, and cement sectors. The former two continued to avail significant volume of credit during FY17, much as they did last year. However, their share of fixed investment in total credit availed by each sector declined, which indicates that, compared to last year, the expansion plans for power and road infrastructure sectors were slightly contained in FY17. Evidently, some of the long-term projects in the electricity sector are at advanced stages of development, with higher requirement for working capital.

[13] The government provided a number of tax incentives to the textile sector, one of which was an exemption of sales tax on import of machinery. As a result, imports of textile machinery rose from Rs 34.6 billion during Jul-Mar FY16 to Rs 42.0 billion during the same period of FY17. The higher imports were mainly concentrated in Q3-FY17 and were attributed to machinery relating to weaving, spinning, looms, winding, embroidery, and other accessories (see **Chapter 5** for details).

[14] SBP had reduced the end-user mark-up rate for LTFF scheme from 7.5 percent to 6 percent for all sectors in July 2015. However, effective from November 2015, it reduced this rate further for textile sector borrowers to 5 percent.

[15] SBP is now refinancing 100 percent of the loans extended by banks/DFIs for imported and locally manufactured new plant/machinery to be used by the export oriented projects of (the entire) spinning and ginning sectors under the LTFF scheme. Earlier, it was refinancing only 50 percent, and that too for only 6 specified processes of spinning sector (for details, see IH&SMEFD Circular No 18 of 2015, dated October 30, 2015).

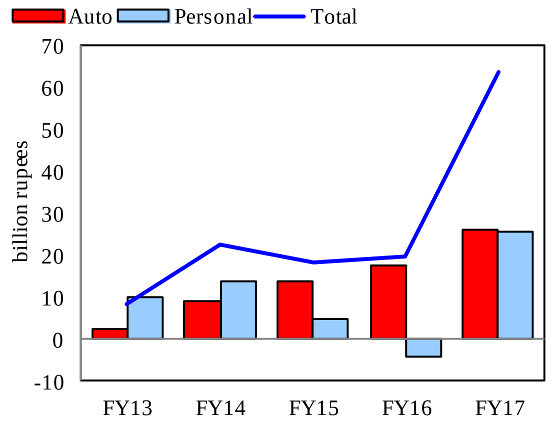
[16] Spinning sector borrowed Rs 19.7 billion during Jul-Mar FY17 under the LTFF, compared to net retirements of Rs 3.2 billion in Jul-Mar FY16. The import of spinning machinery (including machines for winding process) stood at US$ 92.4 million in Jul-Mar FY17 compared to US$ 46.7 million in Jul-Mar FY16.

[17] Dairy firms availed a significantly higher volume of credit during Jul-Mar FY17 compared to last year. Diversification into new product lines to capture market share could explain the demand for fixed investment credit.

Available inventories held back fertilizer sector

Last year, the fertilizer sector availed a significant amount of working capital credit due to both high domestic production as well as imports, which left a glut for the commodity in the domestic market during FY17. As a result, overall activity in the fertilizer sector was fairly subdued during Jul-Mar FY17, and the period was characterized by net retirement of working capital loans.

Figure 3.6: Consumer Financing by Category (Jul-Mar)



Data source: State Bank of Pakistan

Consumer financing picked up pace

While consumer financing was already buoyant during Jul-Mar FY14-FY16, its volume tripled in the same period of FY17.[18] Auto financing continued to hold the biggest share on the back of consistent rise in credit flow during Jul-Mar for four consecutive years (**Figure 3.6**). In addition to low borrowing rates, factors which boosted auto financing in FY17 included: high demand from customers due to emerging transport businesses (such as online taxi services) and release of new car models.[19] Personal loans also showed an impressive turnaround with growth in excess of 20 percent during Jul-Mar FY17.

3.5 Inflation

Average inflation, which remained quite stable in the first two quarters of FY17, increased to 4.3 percent in the third quarter (**Table 3.4**). This

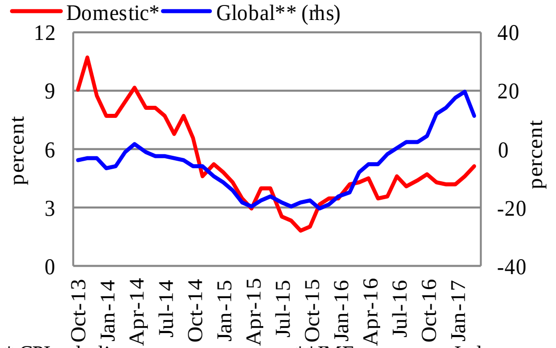
Table 3.4: CPI Inflation
(percent)

	Overall	Food	Energy	NFNE	House rent (HR)	NFNE (w/o HR)
FY16						
Q1	1.7	0.3	-3.7	3.9	5.7	2.9
Q2	2.5	1.8	-1.2	3.8	5.4	2.9
Q3	3.8	3.3	1.7	4.5	5.5	3.9
Jul-Mar	2.6	1.8	-1.1	4.1	5.5	3.2
FY17						
Q1	3.9	4.0	-1.6	4.6	5.8	4.0
Q2	3.9	3.6	-2.1	5.2	6.7	4.4
Q3	4.3	3.8	0.4	5.3	6.6	4.5
Jul-Mar	4.0	3.8	-1.1	5.1	6.4	4.3

Data source: Pakistan Bureau of Statistics and State Bank of Pakistan

[18] During Jul-Mar FY14-FY16, consumer financing averaged around Rs 20 billion, but during Jul-Mar FY17, it rose by Rs 63.9 billion.
[19] The auto industry has introduced a range of new models in Jul-Mar FY17, particularly of Suzuki (Vitara and Ciaz), Toyota (Fortuner and Hilux Revo) and Honda (City, Accord and Civic).

Figure 3.7: YoY change in Global and Domestic Non-Energy Inflation



* CPI exluding energy component ;**IMF non-energy Index.
Data source: Pakistan Bureau of Statistics; State Bank of Pakistan; IMF

rise can be attributed to: (i) the pass-through of increase in international oil prices to domestic prices by the government (on four instances) in Q3-FY17; (ii) a steady increase in domestic demand as evident from the gradual rise in NFNE inflation; and (iii) the impact of a rise in global prices of some key food commodities in the quarter. Nonetheless, it is important to highlight that non-energy inflation in Pakistan has been quite lower than global non-energy inflation (**Figure 3.7**).[20]

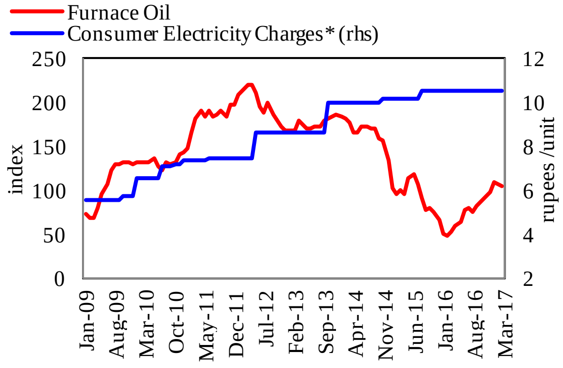
Global oil prices kept increasing in Q3-FY17, though some moderation was observed in the latter part of March 2017. As a result, the government increased the prices of petrol and high speed diesel (HSD) more frequently during Q3-FY17, which ultimately ended the 29-month spell of YoY deflation in fuel prices.[21] Moreover, the deregulation of CNG prices in December 2016 resulted in modest increase in its prices. In addition, LPG prices also remained higher despite explicit regulatory instructions to dealers to bring down prices for household consumption.[22] Resultantly, energy CPI – which was exhibiting deflation for the last nine quarters in a row – recorded inflation during the quarter under review (**Table 3.4**).

Within energy CPI, electricity tariffs remained unchanged, despite changes in

[20] Earlier, the non-energy inflation in Pakistan fell quite sharply in tandem with the global non-energy deflation from July 2014 to October 2015.
[21] During mid-January to 1st March 2017, the government increased petrol and HSD prices on four occasions, by a cumulative Rs 6.7/liter and Rs 6.8/liter. Petrol, HSD and CNG prices rose 0.9, 5.2 and 1.8 percent in Q3-FY17 on YoY basis, compared with fall of 3.9, 7.9 and 4 percent in Q3-FY16. The price of CNG has also gone up by Rs 2.05 per kg between December 2016 and March 2017, following the deregulation of CNG sector in December 2016 (vide Ministry of Petroleum and Natural Resources notification no. CNG-7(9)/16-Price, dated December 16, 2016).
[22] The price of 11.6 kg LPG cylinder rose 7.9 percent in Q3-FY17, compared with a 22.6 percent fall in Q3-FY16.

furnace oil prices (**Figure 3.8**).[23] From April 2016, domestic furnace oil prices recovered, but the consumer electricity tariff remained unchanged. This is mainly because the government reduced gas tariffs for major power producers.[24] It is important to recall here that the share of gas-based power generation in total power generation has increased to 29 percent in FY17.

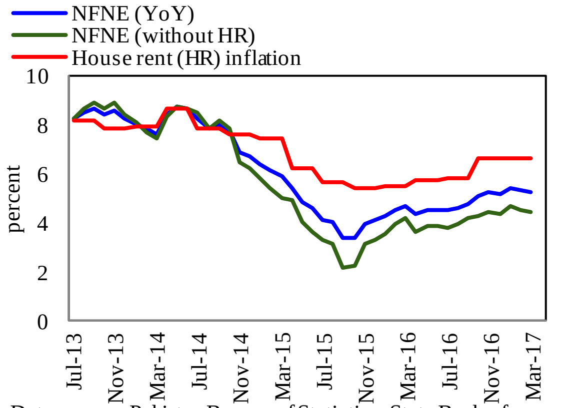
Figure 3.8: Trend in Furnance Oil and Consumer Electricity Tariff



*Average of five different slabs
Data source: Pakistan Bureau of Statistics

Core inflation, NFNE, is gradually inching up, primarily on the back of steady increase in house rent.[25] Typically, house rent exhibits quite persistent inflation; at the start of every quarter, it is revised upward based on regular quarterly surveys in urban areas (**Figure 3.9**).[26]

Figure 3.9: Trend in NFNE vis-a-vis House Rent Inflation



Data source: Pakistan Bureau of Statistics; State Bank of Pakistan

Having said this, NFNE without house rent is also picking up (**Table 3.4**). This is because of education and

[23] In Jul-Mar FY17, electricity generation from furnace oil increased to 23,011 GWh from 21,881 GWh in the same period last year. The share of furnace oil in electricity generation was 30 percent in Jul-Mar period of both FY16 and FY17.
[24] The government reduced gas tariffs for WAPDA, K-Electric and IPPs from Rs 613/mmbtu to Rs 400/mmbtu on December 30, 2016 (source: OGRA notification dated December 30, 2016).
[25] House rent rose 6.6 percent in Q3-FY17, compared with 5.5 percent in the same period last year.
[26] House rent is the single biggest item in CPI basket having weight of 21.8 percent. Pakistan Bureau of Statistics conducts quarterly surveys to assess house rent in urban areas. Anecdotal evidence suggests that the following factors are contributing to persistent increase in house rent: increasing migration from rural to urban areas; demand-supply gap of housing units; increasing cost of construction; rapid increase in land/real estate prices; and public tendency to save/invest in real estate.

health, which recorded double-digit price increases in Q3-FY17. The upward revision in education fees started quite early in the current fiscal year, i.e., from Q2-FY17 onwards, which resulted in 11.2 percent inflation in the education group in the third quarter, compared with 9.2 percent in the same period last year.[27] Likewise, health CPI rose 14.2 percent during the quarter under review, compared with only 3.7 percent in Q3-FY16. This increase mainly reflects an upward revision in medicine prices by a number of pharmaceutical firms.

Meanwhile, food inflation inched up during Q3-FY17 compared to last year (**Table 3.4**). Domestic prices of cooking oil/ghee and rice rose due to pick up in international prices of palm oil and rice in Q3-FY17. On top of this, the prices of perishable food items remained higher in the quarter on YoY basis.[28] Tight supply conditions due to implementation of stricter controls on trade payments, along with prolonged closures of the western border, and increasing transportation costs, were the main explanatory factors for this higher inflation in perishables.[29]

Outlook

Global oil prices, which rose 14.8 percent between November 2016 and May 2017, are forecast to remain around US$ 51.9–55 per barrel for the full calendar year 2017.[30, 31] As mentioned before, the government has passed on the increase in global oil prices only gradually (and partially) from January 2017 onwards, which has been helpful in diluting the second-round impact of rising fuel prices and taming inflation expectations of domestic consumers. However, going forward, recent regulatory changes in the motor fuel industry may lead to important adjustments in retail prices (**Box 3.1**). Some of the impact of these adjustments may be offset by the availability of sufficient stocks of key food items, like wheat and sugar.[32,33] In addition, the existing exchange rate stability

---

[27] In contrast to FY16, when educational fee were revised in Q3, the same fees started to rise from Q2-FY17 in the current fiscal year.

[28] Perishable food inflation rose 8.9 percent during Q3-FY17, compared with only 0.7 percent during same period last year.

[29] Compared to Q1-FY17 where implementation of trade controls along with tension on eastern border contributed to higher perishable prices, tensions on the western borders with Afghanistan resulted in disruption of food supplies in Q3-FY17. Western border closures/tension as reported, also resulted in heavy losses to traders in Pakistan. Furthermore, higher prices of petrol and HSD in Q3-FY17 resulted in rising transportation cost of fruits and vegetables which fed into higher consumer prices.

[30] From November 30, 2016 onwards, Saudi light crude prices oscillated in a band between US$ 45-55 per barrel. On June 16, 2017 it was trading at an average price of US$ 45.1 per barrel.

[31] Sources: IMF forecast as of May 29, 2017 and World Bank forecast as of April 26, 2017.

[32] With domestic consumption at around 24.5 million tons each year, there would be an excess of 1.2 million tons of wheat (for detail see **Chapter 2, Real Sector**). Further, the stock of wheat with

will also help in containing domestic inflation. On balance, therefore, SBP expects the FY18 inflation to stay within the target of 6 percent set by the government.

Box 3.1: Implications of Structural Shifts in the Domestic Fuel Economy

The motor fuel market in Pakistan has always been heavily regulated. Because of far-reaching spillover effects associated with the industry, the government monitors not only prices, but also product quality.[34] Therefore, movement in prices of motor fuel is typically considered as *administered*, which basically implies that global developments and/or the domestic demand-supply gap tends to affect inflation in this sector only when the government decides to pass on the impact to consumers.

While the motor fuel index carries a relatively small weight of 3.03 percent in the country's CPI basket, its actual impact on inflation is larger due to second-round impacts.[35,36] Over the past few years, significant deflation has been observed in this index – large enough to pull down the overall CPI inflation.[37] However, this box highlights recent regulatory changes in the industry which might foreshadow some upward adjustments in the pricing structure in the medium term.

Consumers may need to pay quality premiums

The quality of petrol has been upgraded from RON 87 to RON 92 in Pakistan from November 2016.[38] While consumers will derive benefits from this upgrade – including better engine performance of vehicles and reduced 'knocking' – the shift also entails a higher cost, which may ultimately put upward pressure on prices. For a crude gauge of rising costs entailed by the upgrade, the price differential between RON 87 and (costlier) RON 92 was around US$ 0.1 per liter on average during Nov-Apr FY17.[39]

Prices of HOBC and CNG will now be market-driven

Domestic pricing of HOBC and CNG was deregulated in November and December 2016, respectively. This was followed by an uptick in related prices.[40] In the case of HOBC, anecdotal

---

procurement agencies was approximately 4.9 million metric tons (MT) as of March 2017, compared to 4.6 million MTs as of March 2016.

[33] Sugar recorded 2.3 percent inflation during Q3-FY17, compared with 13.4 percent increase in the same period last year.

[34] Better quality motor fuel is associated with lower CO_2 emissions and environmental degradation.

[35] Motor fuel inflation is derived from the prices of petrol, CNG, HSD and LPG.

[36] In simple terms, the second round impact occurs when producers and service providers (for whom motor fuel is an input) embed the rising cost of fuel into the prices of their goods and services. This puts further upward pressure on the CPI beyond the initial increase in the motor fuel index alone.

[37] The motor fuel index posted a cumulative deflation of 23.8 percent between FY14 and FY16, before inching up in Q2 FY17 by 1.7 percent on YoY basis.

[38] The quality of petrol is assessed from its Research Octane Number (RON), where a higher number denotes better quality. Most countries are using at least RON 92 petrol. In efforts to provide better quality fuel, the government gave two years time to local refineries/OMCs to plan for the production of high grade petrol; however, local producers resisted this move. Ultimately in August 2016, the government decided to import RON92 and provided the product (initially in major cities) using the platform of OMCs in November 2016.

[39] Source: Bloomberg

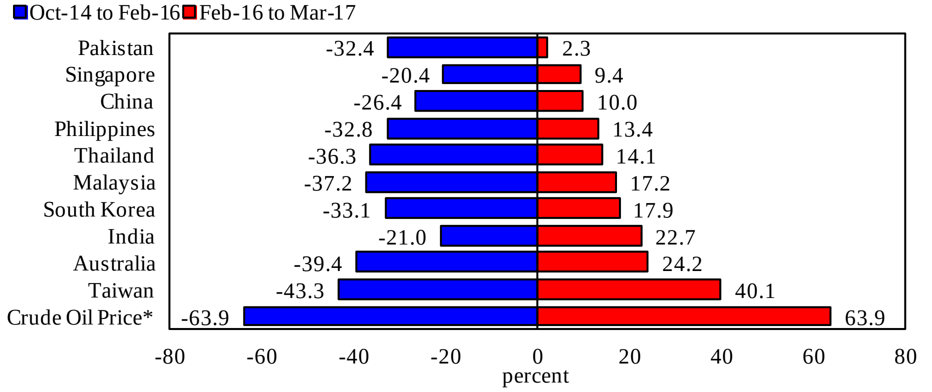
[40] Prior to deregulation, the average price for PSO's HOBC was Rs 73.05 per litre in November

evidence suggests that some sellers resorted to charging excessive margins, as upward ceilings were removed. For CNG, dealers increased prices on four occasions since the deregulation (up to mid-May 2017), citing an increase in input costs – particularly energy-related – during the period.

Price reversals have been contained compared to the benchmark

Globally, the trend in global gasoline prices has reversed (**Figure 3.1.1**). For example, Saudi Arabian Light oil, which traded at US$ 28.9 per barrel in Feb-16, crossed the US$ 51 per barrel mark merely two days after OPEC's agreement on November 30, 2016 to cut production.[41] In this altered scenario, many countries responded by raising domestic fuel prices. Some – like Taiwan and Australia – appeared to be more market-driven, as indicated by their contemporaneous price adjustments in line with global trends. By contrast, while Pakistan's response was fairly compatible in the falling oil price regime, its resistance to raise prices in the rising scenario was quite glaring. Lately, the government has started passing on some of the impact, but this has a political economy dimension: with general elections in 2018, prices may increase going forward, but probably not at a very high pace. This helps explain why Pakistan has thus far passed on the impact of rising global prices only gradually, and still remains among the ranks of countries where the room for further upward adjustments is quite large.[42]

Figure 3.1.1: Pass-through to Domestic Prices in Changing Oil Price Scenario



*Average of Brent, West Texas Intermediate, and the Dubai Fateh
Data source: Bloomberg; www.globaloilprices.com

Implications

Regardless of the pace of pass-through in Pakistan, trends in global oil will continue to influence the country's domestic prices. In this context, the global outlook remains uncertain: while agreed production cuts by OPEC and non-OPEC members in end November 2016 pushed up oil prices temporarily (till end February 2017), the fragile recovery remained vulnerable to, inter alia, increases

2016; by May, the price averaged Rs 81.41 per litre (PSO Altron X). Similarly, average CNG prices rose from Rs 69.8 per kg in December 2016 (pre-deregulation) to Rs 72.05 per kg by April 2017.

[41] This milestone deal marked OPEC's first production cut in eight years. It envisioned reduction in OPEC's output by approximately 1.2 million barrels per day by January. Significantly, even Russia – a non-OPEC member – agreed to cut production by 300,000 barrels per day.

[42] Pakistan ranks 32 out of 170 countries (1 being the lowest) in terms of gasoline prices (source: www.globalpetrolprices.com, accessed May 11, 2017).

in output of US shale and higher global inventories. As a counter measure, several OPEC members agreed (in a meeting held on May 25, 2017) to extend the output cut till Mar 2018. However, this agreement failed to have its desired impact, as prices fell to US$ 50 (on average) soon after the meeting, compared to US$52 per barrel prior to it.

On the domestic front, the post-May 25 dip in global oil prices coincided with the government's decision to cut domestic fuel prices in June 2017.[43] In the bigger picture, it appears that the impact of quality upgrades on domestic prices is yet to materialize. However, there has been one notable fallout already: an increase in import of refined petrol.[44] This is due to the inadequate capacity of local refineries to produce high quality gasoline. The situation calls for fresh investment and technology upgrades for local refineries, as higher import of refined products is unsustainable in the long run, and could stoke inflationary pressure. In the meantime, it is plausible that domestic petrol prices might gradually be raised in the medium term to offset some of the incremental cost of upgrades. On the face of it, there appears to be some room available for such a measure, since the pass-through in Pakistan has lagged behind the increase in global crude oil prices thus far (**Figure 3.1.1**).

[43] The government announced reduction of Rs 1.2 and Rs 1.6 per liter in prices of petrol and HSD for June 2017.
[44] The import-to-sales ratio of petrol rose from 56.7 percent in FY14 to 75.3 percent during Jul-Mar FY17.